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Honolulu City & County, Hawaii

Credit Profile

US\$196.505 mil snr In wstwtr sys rev bnds ser 2006 A due 07/01/2036	AA-
Sale date: 21-AUG-2006	
US\$27.79 mil snr In wstwtr sys rev bnds ser 2006 B due 07/01/2032	AA-
Sale date: 21-AUG-2006	
US\$55.455 mil snr In wstwtr sys rev bnds ser 2006 C due 07/01/2023	AA-
Sale date: 21-AUG-2006	

AFFIRMED

\$152.815 mil. Honolulu City & Cnty sr wstwtr (FGIC)	AAA/AA-(SPUR)
\$482.553 mil. Honolulu City & Cnty wstwtr sys 2nd res (jr) rev bnds ser 1998 & 2003	A+

OUTLOOK:

STABLE

Rationale

Standard & Poor's Ratings Services assigned its 'AA-' rating to the City and County of Honolulu, Hawaii's 2006 A-C wastewater system revenue bonds. At the same time, Standard & Poor's affirmed its 'AA-' underlying rating (SPUR) on the system's outstanding parity bonds and its 'A+' rating on the system's \$482.55 million in subordinate debt.

The rating reflects:

- A diverse and largely residential service area of the wastewater system, serving 71% of the population of Oahu, Hawaii's most populous island;
- System capacity that is adequate to meet both current and projected flow;
- Financial policies that include a debt service coverage target of no less than 1.6x on senior lien debt and 1.25x on all debt; and
- Good cash reserves, supported by a plan to maintain at least three months of operating expenses in reserve.

The above strengths should enable the department to manage a capital plan that will require \$933.2 million in financing between 2007-2011, and \$2.5 billion before 2017.

The bonds are secured by a pledge of net operating revenues of the wastewater enterprise.

The Department of Environmental Services of the City and County of Honolulu was created in 1998 as an enterprise fund to manage the wastewater system. The system serves most of the city and county, except for certain isolated areas that rely on private systems. The system serves more than 600,000 residents, or 71% of the city and county. Average system demand is 113 millions of gallons per day (mgd), or about 74% of the system's capacity of 151 mgd. With relatively slow growth in the population of Oahu, projected to total 7% over the next 10 years, the system's capacity should be sufficient.

A multiyear rate increase that includes a 25% increase in fiscal 2006 and a 10% increase each year through fiscal 2011 should help maintain strong finances even as capital-related debt service costs increase. Until the recent multiyear rate increase, the department had not increased the rates customers pay for wastewater service since 1993. Current rates of \$44.25 for 7,000 gallons are moderate for similarly sized city wastewater systems. The Department of Environmental Services relies on the Honolulu Board of Water Supply to bill for most wastewater service and water service on a single bill. Rates are to be increased substantially in support of the department's capital plan, beginning with a 25% increase effective July 1, 2006. Rate increases also are expected each year after fiscal 2006, and the typical monthly residential bill is expected to grow to \$64.80 by 2011, an overall increase of 46.4%.

Financial targets are supported by policies. The department has a policy to maintain a target senior lien debt service coverage ratio of at least 1.6x, and 1.25x on all revenue debt. Based on 2005 audited financial statements, net revenues available for debt service provided good 2.3x coverage of debt service on senior and junior bonds. Including other obligations such as general obligation reimbursable bonds and state loans, coverage was an adequate 1.18x. The amount of connection fee revenue included in the coverage ratios is minimal. Additionally, the planned rate increases are intended to enable the department to maintain a minimum of three months of operating expenses in reserve. In 2005, cash reserves were strong at \$42.3 million, or 226 days' cash.

The department's capital plan will require additional debt financing. In addition to these series 2006 bonds and the prior series in 2005 of about \$150 million, \$592 million in debt is expected through fiscal 2011. The department's capital plan involves projects required as a result of consent decrees between the department and federal and state regulatory authorities.

Outlook

The stable outlook reflects Standard & Poor's expectation that rate increases will enable good financial performance as the city and county makes progress in its capital plan, while maintaining good operating reserves.

Economy: Supported By Tourism, Defense

Economic fundamentals remain strong. The Honolulu economy remains reliant on defense and tourism, but these are industries that have held steady in recent years. Hickam Air Force Base, one of the leading employers on Oahu, is expected to benefit from the arrival of the C-17 cargo plane, which will support an estimated 500 new jobs. Occupancy at hotels is 86.1% so far in 2006, and the average room rate of \$155 is 12.2% better than the same figure last year and is a five-year high, although total arrivals are down slightly (4.5% year-to-date). The four leading employers—Pearl Harbor Naval Complex, Schofield Barracks and Fort Shafter, the Marine Corps Base Hawaii Kaneohe Bay, and Hickam Air Force Base—have a combined employment of about 64,000 personnel. Tourist-dependent employers include large hotel companies Marriott International, Hilton Hotels,

and Outrigger Hotels, as well as Aloha Airlines and Hawaiian Airlines, and have a combined employment of 16,000.

The system is in the middle of a \$2.5 billion, 20-year capital plan, which is revised and adjusted periodically. In the near-term, 2007 through 2011, the system's capital spending is anticipated at \$933 million, largely financed through revenue bonds. Only about 9% of the needs of the system are growth-related, with most of the program intended to improve collection and treatment systems. Among the more urgent needs of the system is the replacement of old and corroded pipes that allow inflow and overflow during rainy seasons, a problem that, if unresolved, could lead to environmental violations and disruption of service. This occurred for a brief period during heavy rains in spring 2006 near Waikiki Beach; service was restored within days.

Finances And Debt

The system's debt level is expected to rise as it continues its capital program. Revenue bonds secured by net system revenues on both a senior and subordinate basis are the leading financing source for capital projects. Rate increases have been pre-approved through 2011. Management policies adopted by city council set minimum cash reserve levels and debt service coverage levels, such as a three-month operating reserve. Before the issuance of the series 2005 and 2006 bonds, the system had \$332.6 million in senior lien revenue bonds outstanding and \$482.55 million in junior lien revenue bonds outstanding. Coverage on all the system's bonds is not expected to be lower than 1.3x, according to financial projections that incorporate approved rate increases and modest system growth. Combined debt service expenditures on the system's bonds, both senior and junior, are going to increase substantially, to \$107 million in 2011 from \$22.6 million in 2005.

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